industry at a time "when markets for telecommunications goods and services are becoming increasingly competitive, nationally and internationally."[67] That same logic applies here. Indeed, the Commission's move toward price regulation (though not yet a "pure" price cap plan) presaged Congress' later enshrinement, in the Telecommunications Act of 1996, of the principle of using market-oriented regulatory frameworks -- rather than direct regulatory intervention -- to set efficient prices.[68]

Considered against this backdrop, the prescriptive approach to access charge reform suggested as an alternative in Part VI of the NPRM contravenes the deregulatory thrust of the Commission's own policy initiatives and of the Congress in enacting the 1996 Act. As a general proposition, firms have better knowledge of their costs and demands than do regulators, and prices set by regulators are likely to generate economic waste because they are based on inefficient assumptions about cost and demand.[69] Furthermore, the prospect of regulatory ratemaking reduces LEC incentives to make efficient investments in telecommunications

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67 *LEC Price Cap Order*, 5 FCC Rcd 6786, 6790, ¶ 28 (1990)

68 *See, e.g.*, 1996 Act Conference Report, Report No. 104-458, 104th Cong., 2d Sess. (1996), at 1 (Congressional intent to create "pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans"). Thus, in Sections 251 and 252 of the 1996 Act, for example, Congress created an interconnection regime that relies on private party negotiation in the first instance to set interconnection rates, since the parties to such agreements inherently have a better understanding of their costs and marketplace dynamics than regulators do. *See* 47 U.S.C. §§ 251-252.

69 *See* J. Haring and J. Rohlfs, "Comments on Pricing Flexibility Issues" (Jan. 10, 1996), at 9, submitted as Attachment 1 to Reply Comments of BellSouth Telecommunications, Inc. (Jan. 11, 1996), CC Docket No. 94-1.

infrastructure to the extent that inefficient pricing limits the ability of these carriers to reap appropriate rewards from the deployment of advanced telecommunications infrastructure.[70]

BellSouth therefore strongly opposes any approach under which, at a time when Congress, the Commission and the States have set the stage for unprecedented competition in the telecommunications marketplace, the Commission would adopt a *more* rather than *less* interventionist regulatory approach. The NPRM does not demonstrate either a sufficient legal or policy predicate for such intervention, and concurrently, acknowledges the potentially enormous administrative burdens on the Commission that would be engendered by an approach that would require the agency to make detailed determinations of appropriate price levels for multiple services throughout the country.[71]

In all events, however, it is quite clear that any approach adopted by the Commission to reform access charges -- prescriptive or not -- must permit LECs to recover *all* of their costs. As a fundamental matter of economics, when firms are not permitted to price their products or services to produce revenues sufficient to cover total costs, they cannot survive over time.[72] As a fundamental matter of law, a local exchange carrier must, in addition to the forward-looking costs

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70 *Id.*

71 NPRM at ¶ 143. Moreover, AT&T claimed policy justification for a prescriptive approach, *i.e.*, that regulatory intervention is necessary until "competitors have a chance to build their own networks," Communications Daily, *AT&T Urges Halving Access Charge Payments for IXCs* (Jan. 24, 1997), rings hollow. AT&T has made it clear that it has no intention of constructing local facilities anytime soon. *See AT&T's New President Is Wasting No Time In Shaking Things Up,* Wall St. J., Dec. 24, 1996, at Al. AT&T transparent attempt to shackle the LECs with onerous and unnecessary regulation for as long as possible should be rejected.

72 *See* Affidavit of Professor Jerry A. Hausman (May 13, 1996), at ¶¶ 11-12, submitted as Attachment 1 to Comments of United States Telephone Association (May 16, 1996), CC Docket No. 96-98 ("Hausman").

measured by methodologies such as TSLRIC or TELRIC, be allowed the opportunity to recover joint and common costs; the embedded cost of past LEC investment in the network; and the cost of government-imposed subsidies of residential and other services.

Prescriptive regulatory action by the Commission that precludes LECs from recovering their total costs -- such as the prescription of TSLRIC-based access rates -- will simply spawn inefficient and sub-optimal network investment, as LECs over time are deterred from making network improvements by the very real risk that their costs will not be recovered.[73] Considered as a legal matter, such action would be confiscatory, because LECs had and have a legitimate, investment-backed expectation that they will be permitted to earn a compensatory return on the total costs of deploying their networks.[74]

BellSouth strongly urges the Commission to flatly reject a prescriptive approach to access charge reform.[75] While parties such as MCI may contend that a market-based approach is "inadequate to the task of reforming access,"[76] they have proffered no evidence that this is so, and in the absence of such evidence, a market-based approach is the one that the Commission should adopt.

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[73] Such an approach would also be bad policy. It would undermine investor confidence because there would be reason to believe that any regulatory decision will be honored. If this Commission can ignore the regulatory promises of its predecessors, then there is no credibility to that can be attached to the regulatory process. *See also* Attachment 2, Haring and Rohlfs at 11-12.

[74] *See Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

[75] The Commission notes that one intermediate goal of either a market-based or prescriptive approach is to drive interstate access rates to "economically efficient levels." NPRM at ¶ 220. BellSouth also believes that the goal of reducing regulation and attendant distortions that blunt both competition and productivity gains is equally important. This is a goal that the prescriptive approach outlined in the NPRM fails to promote.

[76] NPRM at ¶ 218.

A. There is No Basis for the Commission to Readjust LEC Rates to TSLRIC Based Cost Levels (Paras. 223-227)

The Commission asks in the NPRM whether it should require a re-initialization of price cap indices ("PCIs") on the basis of a TSLRIC-based study as one means of implementing the proposals of AT&T and MCI that access rates be set at forward-looking costs.[77] As a threshold matter, the Commission lacks the legal basis for ordering such a re-adjustment of LEC rates. The Commission's authority to order LEC rate reductions is grounded in Section 205 of the Communications Act. That section, at a minimum, requires an express finding that existing LEC charges "are or will be unlawful" before the agency can prescribe or represcribe carrier rates.[78] In this case, there is no evidence that LEC rates are unreasonable; indeed, the Commission's most recent performance review of the LEC price cap plan expressly confirmed this fact.[79] Thus, there is no legal basis for the Commission to require LECs to reduce their PCIs.[80]

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77 NPRM at ¶ 223.

78 *Third Report and Order*, MTS and WATS Market Structure, 93 FCC 2d 241, 256 (1983); *see LEC Price Cap Order*, 5 FCC Rcd at 6817, ¶253.

79 *LEC Price Cap Performance Review Order*, 10 FCC Rcd 8961, 9072-73, ¶ 254 (finding "no evidence in the record to suggest that rates under price caps" are outside the zone of reasonableness).

80 Contrary to the suggestion in the NPRM, the Commission's reinitialization of price cap indices to correct a perceived error in the underlying economic study that determined the X-Factor, *see* NPRM at ¶ 223, *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9069-73, is a fundamentally different circumstance than deciding here to adjust rates based upon *new* TSLRIC or TELRIC studies. Unlike the price cap scenario, there is no indication here of error or unlawfulness associated with LEC access rates. And as the courts have held, to "permit the Commission to achieve the same result as it would pursuant to a Section 205 rate prescription, by circumventing the statutory hearing and finding requirements on the basis of its claimed broad inherent regulatory power, would defeat the purpose of Section 205 and vitiate the statutory scheme" of the Communications Act. *AT&T v. FCC*, 487 F.2d 864, 874-75 (2nd. Cir. 1973).

In any event, however, a prescribed reinitialization of LEC access rates to TSLRIC or TELRIC derived rate levels would be wholly inappropriate. To begin with, such a reinitialization would be fundamentally inconsistent with the rationale for adopting price regulation for the LECs in the first instance. A price cap system is predicated upon breaking the link between prices and regulation-based cost levels. Yet that is precisely the link that the Commission would re-introduce by readjusting LEC PCIs for access services on the basis of TSLRIC-based cost studies. And to the extent that rates prescribed based upon such regulatory estimates of "cost" are in fact too low, the effect on LEC productivity incentives will be pronounced and disastrous. Furthermore, there are fundamental problems with using TSLRIC or TELRIC as the measure of LEC "costs."

First, the problems associated with current FCC TELRIC models are well-documented.[81] The FCC to date has not based its TELRIC cost methodology on actual LEC infrastructure costs, but instead upon the costs of an idealized hypothetical network constructed with the most efficient existing technology -- an inherently unreasonable standard that simply does not match marketplace reality.

Second, even putting aside the modeling issues, there are legitimate costs incurred by LECs that simply remain unaccounted for in TSLRIC and TELRIC costing methodologies. Once again, any true measure of LEC "costs" must include joint and common, embedded separations

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[81] *See e.g.*, Iowa *Utilities Board v. FCC*, No. 96-3321 (and consolidated cases), Brief for Petitioners Regional Bell Companies and GTE (Nov. 18, 1996).

and subsidy costs to prevent under-recovery.[82] However, the combination of requiring LECs to shoulder all of the risk of failed network investment while also affording them no opportunity for legitimate total cost recovery means that, over time, LECs will simply invest less in network improvements.[83] For the Commission to mandate such a result is not only bad public policy, but as mentioned, raises serious constitutional concerns as well.[84]

Finally, reinitializing PCIs to levels that are consistent with the TSLRIC of incumbent LEC access services would impose needless and significant administrative burdens on the Commission. In this regard, the suggestion in the NPRM that State regulators might in effect be conscripted to set interstate access rates in order to alleviate the Commission's administrative burden is ill-conceived and unworkable.[85] The Commission has no power to order State Commissions to conduct or evaluate TSLRIC cost studies.[86] And in BellSouth's service territory,

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82 The Commission has conceptually acknowledged that LECs should recover some allocation for forward looking common costs. *See Local Competition First Report and Order*, CC Docket No. 96-98 (released Aug. 8, 1996), at ¶694.

83 At the same time, investors will demand higher returns before they will risk their capital.

84 As BellSouth, GTE and the other RBOCs have observed, there are at least three related takings issues that arise in connection with FCC-mandated, TELRIC-based interconnection prices that are equally applicable to a prescriptive approach to access charge prices here. Specifically, FCC prescription of TELRIC or TSLRIC-based access rates would (1) require LECs to sell at prices that do not cover all of their costs; (2) deprive LECs of the opportunity to earn a fair rate of return on prudently invested capital; and (3) would destroy, without compensation, the regulatory bargain that formed the basis of prior LEC investments. *See Iowa Utilities Board v. FCC*, No. 96-3321 (and consolidated cases), Reply Brief for Petitioners Regional Bell Companies and GTE (Jan. 6, 1997), at 24 (citations omitted).

85 NPRM at ¶ 224.

86 Contrary to the suggestion in the NPRM, the Commission's permissive or mandatory Joint Board authority, codified at 47 U.S. C. § 410, does not give the Commission power to conscript the states into assuming the admittedly "significant and potentially costly burdens" of a prescriptive approach in the guise of ensuring "coordinated treatment between jurisdictions." NPRM at ¶ 222. Indeed, any attempt by the Commission to compel the states to do so would be (Footnote Continued...)

for example, all nine State commissions have adopted price regulation and have no need to conduct such studies for intrastate ratemaking purposes. Moreover, the legislative statutes creating these State commissions do not, to BellSouth's knowledge, authorize them either to set interstate rates or to participate in proceedings to prescribe interstate rates. Thus, to the extent the Commission's pursuit of a prescriptive approach to setting access charge rates would (needlessly) increase administrative burdens, such "costs" cannot be delegated by the Commission to other entities.

B. LEC Access Rates Should Not Be Reinitialized on Any Other Basis (Paras. 228-230)

The Commission speculates that, in the event that reinitialization of PCIs based on TSLRIC cost studies or TELRIC models is not feasible, the Commission could nonetheless reinitialize PCIs on some other basis, *e.g.*, by reference to carrier earnings levels. The Commission suggests, for example, that it could reduce PCIs to a level that would result in rates targeted to yield a rate of return of no more than 11.25 percent, or that it could prescribe a new rate of return, and then reinitialize rates on that basis.[87]

BellSouth does not believe that legal or factual predicates exist for the Commission to exercise its Section 205 power to prescribe LEC access rates. But even if those predicates existed, the setting of access rates by reference to a regulated rate of return makes little policy sense. Such action would again be fundamentally inconsistent with the theory of price caps, which does not measure earnings, but instead seeks to stimulate carriers to increase profits by

unconstitutional. *See New York v. United States,* 505 U.S. 144, 161 (1992) (under Tenth Amendment principles, States cannot be directly compelled by federal government to "enforce a federal regulatory program") (citation and internal quotation marks omitted).

[87] NPRM at ¶ 228

becoming more internally and operationally efficient, and by developing new services and technologies. As the NPRM itself points out, the reduction of PCIs based on LEC earnings could have "a negative effect on the productivity incentives of the LEC price cap plan."[88] Indeed, a reinitialization in the manner proposed would be fundamentally unfair to LECs that have succeeded in gaining higher earnings by improving their productivity beyond the challenging targets contained in the Commission's price cap rules. For the Commission to confiscate those productivity improvements unnecessarily would be arbitrary in the extreme.

Over time, competition will drive LEC access prices to efficient, market-based levels (and not to some hypothetical, computer-modeled estimate of TSLRIC or TELRIC). There simply is no justification, however, for the Commission to prescribe lower access rates today, and especially not by reference to rates of return that have little meaning in a price cap environment.

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88 *Id.* at ¶ 230.

C. Revision of the LEC Price Cap Plan (Paras. 231-235)

Another idea proposed by the Commission in connection with a prescriptive access charge approach is to create a policy-based mechanism similar to the Consumer Productivity Dividend ("CPD"), the extra calculation grafted onto the X-Factor when price caps were initiated, designed to ensure that the first benefits of incumbent LEC productivity growth under price caps would flow to access customers in the form of reduced rates.[89] The Commission's notion here is that a similar mechanism could be calculated based upon some fraction of the percentage difference between current access rates and rates based upon "economic cost," which would in turn, like the CPD, be attached to the LEC X-Factor.

With respect to the CPD, BellSouth, USTA and others have already pointed out that the mechanism has outlived its usefulness.[90] The elimination of barriers to competitive entry will enforce efficient market pricing relationships far more effectively. A market-based, competitive approach is inimitable with such a regulatory overlay. Certainly, the overall pricing pressure associated with the ubiquitous availability of UNEs priced at efficient market-based rates provides no economic basis to preserve the CPD burden on the ILECs.

BellSouth sees no legal or economic justification for creating a new CPD-like mechanism. While such a mechanism is perhaps a more explicit and honest method of manipulating the price cap plan, it is also utterly arbitrary, and would merely have the effect once again of confiscating LEC productivity gains for the benefit of the IXCs.[91]

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89 *See Id.* at ¶ 232; *LEC Price Cap Order*, 5 FCC Rcd at 6799.

90 *See e.g.*, BellSouth Comments, CC Docket No. 94-1 (January 16, 1996) at 28.

91 And with no assurance that the IXCs will flow these benefits through to consumers.

With respect to the Commission's suggestion that it might rule on pending issues raised in the *Fourth Further Notice*,[92] BellSouth has no objection, but strongly opposes the proposals of AT&T and MCI to adopt a higher X-Factor or set of X-Factor options.[93] BellSouth and USTA have demonstrated in the price cap proceeding that using actual measurements of productivity improvements under price cap regulation does *not* require an increase in the X-Factor. BellSouth and USTA also have demonstrated that the studies submitted by AT&T and MCI to support a contrary conclusion were flawed, both conceptually and in their application.[94] The AT&T and MCI positions amount to little more than a request for the Commission to effect a naked wealth transfer from LEC to IXC shareholders. The record in the price cap proceeding simply does not justify an increase in the X-Factor. The actual achieved improvement in LEC total factor productivity under price cap regulation provides an outside limit on a reasonable productivity target for the future, and the X-Factor should be set no higher than that level.[95]

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92 NPRM at ¶ 233.

93 *See Id.* at ¶ 233; AT&T Comments, CC Docket No. 94-1 (Jan. 11, 1996); MCI Comments, CC Docket No. 94-1 (Jan. 11, 1996).

94 *See. e.g.*, Reply Comments of BellSouth, CC Docket No. 94-1 (Mar. 1, 1996) Attachment 1, Frank M. Gollop, "An Economic Analysis of the AT&T and Ad Hoc Comments" (Mar. 1, 1996). As BellSouth has noted previously, a price cap LEC seeking to achieve the productivity targets that AT&T and MCI have advanced would have to improve its productivity each year by almost *three* times the level imposed by the Commission in the now-defunct AT&T price cap plan, and by nearly *thirty* times the level of productivity achieved by the competitive U.S. economy as a whole, and the burden of such targets would be cumulative on price cap LECs year after year. Such results plainly are absurd.

95 With respect to the use of a forward-looking cost of capital and economic depreciation rates, *see* NPRM at ¶ 233, BellSouth notes that the Christensen studies submitted on behalf of USTA in CC Docket 94-1 incorporated both economic depreciation rates and an estimate of the forward-looking cost of capital. As an Attachment to the United States Telephone Association's comments in this proceeding Christensen has updated the Total Factor Productivity model. Based on this analysis, BellSouth supports the United States Telephone Association's proposal for an 'X' factor of 2.7% with no earnings sharing.

Finally, the Commission has asked whether it should change the rules governing the justification of tariff filings that cause the API for a basket to exceed the PCI.[96] BellSouth believes that there is no need to change the showing required for above-cap filings. First, no LEC has ever made an above-cap filing in the six years since price caps were initiated. More fundamentally, the stringent Commission review standards and the extensive cost showing required for LECs to justify an above-cap filing makes it unlikely that LECs will ever do so. The existing rules are more than adequate to protect ratepayer interests.

D. The Commission Cannot and Should Not Prescribe Prices for Individual Access Services (Paras. 236-238)

The Commission also asks whether, in connection with a prescriptive approach, it should act to ensure that price cap LECs adopt efficient rate structures.[97] This most bitter flavor of the Commission's prescriptive approach is embodied in the suggestion that the Commission might "require LECs to conduct TSLRIC cost studies, and create new prices for individual interstate access prices on the basis of those studies."[98]

BellSouth believes that the best way for the Commission to promote efficient rate structures is to relieve LECs of the artificial rate structures mandated by the Part 69 access charge rules. The Commission's own findings with respect to the inefficiencies buried in the current prescribed rate structure provide powerful evidence that a prescriptive approach to rate structure is unlikely to result in economic efficiency. While BellSouth believes that the revisions proposed in Part III of the NPRM would improve the existing access rate structure, the better solution

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96 NPRM at ¶¶ 234-235.

97 *Id.* at ¶ 236.

98 *Id.* at ¶ 238.

would be to remove the rate structure rules altogether, and to allow the market to decide optimal LEC rate structures. A prescribed (or represcribed) structure is neither required nor in the public interest. As discussed in Section VII of these comments, any rate structure established by the Commission should not preclude a LEC from offering new services or from packaging existing services to meet customer demand.

With regard to prescribing access rates directly, BellSouth has already discussed the legal and policy problems that would attend a Commission attempt to reprice access at TSLRIC-based rates. Furthermore, the Commission itself has noted the problems of applying a forward-looking economic cost methodology to pricing services like interstate access. Because separate services are typically provided over shared network facilities, many costs will be joint and common, and accordingly, any prescribed allocation of joint and common costs will be economically arbitrary when compared to the way markets recover costs.[99] Indeed, the large number of joint and common costs in the provision of interstate access services makes it unlikely that a centrally planned prescriptive approach could ever hope to approximate rates that reflect economic efficiency. A prescriptive approach simply should not be adopted by the Commission.

E. Phases For a Prescriptive Approach (Paras. 239-240)

While BellSouth believes that a prescriptive approach, which would require a specific finding under Section 205 of the Act, is contrary to the principles of sound economics and is contrary to the public interest, BellSouth would emphasize that the Commission's desire to transition interstate access charges to economically efficient levels does not relieve the Commission of its legal and public policy obligations to afford LECs the opportunity to recover

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99 *See id.* at ¶ 237.

the capital that they have prudently invested in facilities devoted to public use. The historical costs of past LEC network investments, and the investments of the LECs allocated to the interstate jurisdiction by the separations process are real costs. The fact that such costs may not be included in a TSLRIC estimate of forward-looking economic costs does not mean that such costs do not exist, or that LECs should not be entitled to recover them; it is instead an indicator that TSLRIC is not an adequate or appropriate economic measure of LEC costs.[100]

The transition mechanisms mentioned in the NPRM in connection with the prescriptive approach simply ignore the fundamental economic and legal obligation of the Commission to permit LECs to recover their costs. While BellSouth supports the Commission's goal of bringing competition to the interstate access market, BellSouth and other LECs are entitled to and should be granted the opportunity to recover their total firm costs in the event that the Commission adopts a prescriptive rather than market-based approach to access reform.

VI. TRANSITION ISSUES

A. Universal Service Joint Board Recommended Decision (Paras. 242-246)

In the NPRM, the Commission observes that the new federal universal service fund should require an adjustment to interstate access charges to remove the implicit support that will be recovered through the universal service fund. In the universal service proceeding, BellSouth has advocated that interstate access charges should be adjusted to reflect the net universal service funds received.[101] Indeed, in its December 19, 1996 comments in CC Docket 96-45, BellSouth

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100 *See* Hausman at ¶ 3.

101 Because LECs will have to contribute to the universal service fund, access charge reduction that would occur as a result of receiving universal service support must be offset by the amount the LEC has to contribute to the Universal Service Fund.

recommended that universal service funds first be applied to reducing carrier common line charges. If the universal service fund is adequately sized, universal service support could also be used to reduce the TIC. Any universal service support that remains after reducing CCL charges and the TIC can be applied to reduce local switching (since the functionality is included within the definition of universal service).

The reductions would be effectuated by making an exogenous change to the price cap basket or service category to which the support is being applied. Under BellSouth's approach, the amount of the exogenous change and the basket/service category to which it applies is readily determinable.

B. Treatment of Any Remaining Embedded Costs Allocated to the Interstate Jurisdiction (Paras. 247-248)

As the NPRM observes, a number of long distance carriers have highlighted the difference between the revenues generated by access charges based on embedded costs allocated to the interstate jurisdiction, and the revenues that would be introduced by basing access rates on the Commission's version of the forward-looking economic cost of access services.[102] AT&T of course characterizes that differential as "pure uneconomic subsidy to monopoly incumbent local exchange carriers," arising from alleged over-allocation of costs to the interstate jurisdiction, inclusion of retail and other costs unrelated to the provision of access, understatement of incumbent LEC productivity, and other purported historical inefficiencies.[103] AT&T's characterization is thoroughly misleading and fundamentally incorrect.

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102 NPRM at ¶ 247.

103 *Id.* at ¶ 247, citing *AT&T November 22 Letter* at 1-2.

In fact, the costs referred to by AT&T are actual LEC costs of constructing the facilities that IXCs use to reach their customers -- costs that have been allocated to the interstate jurisdiction by the mandatory jurisdictional separations process. In addition, many of AT&T's cost estimates are based upon unrealistic assumptions. For example, AT&T excludes all loop costs from its calculation of the incremental cost of providing interstate access, claiming glibly that such costs should be recovered directly from end users. Yet that assertion is utterly disingenuous. As AT&T well knows, the Bell Operating Companies ("BOCs") and GTE historically have been limited to recovering their costs through some combination of interstate end user and carrier access charges, while the Modified Final Judgment ("MFJ") and GTE consent decree prohibited the BOCs and GTE from providing interstate services to end-user customers.[104] Unless or until the Commission permits full cost recovery from end users, LECs will have to continue to recover loop and other costs assigned to the interstate jurisdiction through carrier access charges.[105]

Likewise, although MCI attributes a large portion of the difference between accounting and "economic" costs to "over-built plant" and "excess customer operations expenses," MCI has never introduced any credible evidence to support such claims. Price cap LECs have been operating for six years under a regulatory regime designed to provide unambiguous incentives for LECs to reduce costs and to adopt the most efficient and cost-effective investment strategies

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104 Under the MFJ, some BOCs were permitted to provide interstate services to end users in defined "corridors," such as New York/New Jersey and District of Columbia/Northern Virginia. Most BOCs received only *de minimis* revenues from such services.

105 The Universal Service Joint Board has already recommended that there be *no* increase in the current end user charges for primary residential and single-line business lines. See Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Recommended Decision*, at ¶ 754.

possible. MCI can point to nothing that suggests that LECs have not acted on those incentives.[106] The fact that LECs' actual costs are not on all fours with flawed computer models highlights those models' inadequacy as measure of LECs' real costs. It does not mean that LEC costs have been or are excessive or imprudently incurred.

Lost in a cyberspace of Hatfield models and hypothetical networks, AT&T and MCI simply refuse to confront the reality that the embedded costs of LEC network investments are real costs that LECs incur. If LECs cannot recover these costs, they will have a reduced incentive to upgrade and maintain their networks as they seek to offset the shortfall of revenues against total costs and to avoid the risk of again being unable to recover historical costs.[107] Future LEC investment decisions "will be critically affected by the fact that returns will have to be more sharply discounted to reflect the price reductions that will occur with the next cost-reducing technological change."[108] Reduced and distorted network investment is thus the inevitable consequence of denying the recovery of LEC embedded costs.

In short, the Commission must allow LECs an opportunity to recover their prudently incurred costs of building the networks that have provided quality and universal service to the American public. A contrary result would be unlawful and unfair.

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[106] Furthermore, under rate of return regulation, LEC capacity investments were subject to state and federal rate base reviews, and in may instances, LECs were *required* by regulators to make substantial network investments, *e.g.* provisioning 800 databases or implementing equal access. As USTA has observed, those investments "have had their 'day in court,' and cannot now be attacked post hoc in order to deprive ILECs of due recovery of embedded costs." USTA Reply Comments, CC Docket No. 96-98 (May 30, 1996), at 24-25.

[107] *See* USTA Reply Comments, CC Docket No. 96-98 (May 30, 1996), at 23; Hausman at ¶ 11.

[108] USTA Reply Comments, CC Docket No. 96-98 (May 30, 1996), at 24 (citing Hausman Reply Affidavit at ¶¶ 6-9).

1. Nature and Magnitude of Any Remaining Interstate-Allocated Costs (Paras. 249-255)

The Commission has noted that some of the differences between incumbent LECs' interstate-allocated embedded costs and forward-looking costs may be traced to "past regulatory practices," *i.e.*, (1) the magnitude of embedded costs apportioned to the interstate jurisdiction through the jurisdictional separations process and (2) the under-depreciation of incumbent LEC assets.[109]

At the outset, BellSouth would note that, to some extent, the Commission's search for the sources of the difference between LEC embedded costs assigned to the interstate jurisdiction and TSLRIC- or TELRIC-based estimates of forward-looking costs produced by computer models is an errant quest. The costs that are relevant for interstate ratemaking purposes are jurisdictionally separated, embedded LEC costs. Absent a showing of imprudent investment -- and there has been none submitted -- LECs have a right to have a reasonable opportunity to recover those costs. The Commission's intention to make prospective changes to the jurisdictional separations process does not relieve it of its obligation to provide the LECs with the opportunity to recover those costs defined by Part 36 of its rules as interstate costs.

With respect to depreciation, the NPRM is correct in suggesting that a significant portion of the perceived difference between forward-looking and embedded costs of providing access services can be traced to under-depreciation of LEC assets. Regulatory depreciation of LEC plant is and has been far slower than economic depreciation. The effect over time of the failure of

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109 NPRM at ¶¶ 249-251.

depreciation rates to keep pace with the rapid technological displacements and the loss in economic value has been depreciation accruals set at inappropriately low levels.

Finally, the Commission has proposed to fix a date certain, such that some or all of the unrecovered embedded costs incurred before that date might be eligible for special recovery mechanisms, while costs incurred after that date would be regarded as incurred "under the new competitive paradigm" of the 1996 Act and consequently accorded no special treatment.[110] BellSouth believes that such an approach is workable, but only if (1) the date set by the Commission is prospective in nature, *e.g.*, the date of the order in this proceeding, and (2) the Commission forbears from prescribing LEC depreciation rates as of that date. Since at least 1987 (well before the implementation of LEC price caps), BellSouth has repeatedly urged the Commission to permit LECs to control their own depreciation rates, and the Commission has repeatedly declined to engage in depreciation reform that would permit carriers to recover their investments in a timely fashion. With the emergence of competition, the need for such flexibility is now imperative,[111] and the Commission should delay no longer in providing the LECs with

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110 NPRM at ¶ 255.

111 As Strategic Policy Research (SPR) has observed:

> [T]o honor explicit and implicit commitments to investors, regulators need to capital recovery *before* competition via unbundled elements becomes widespread.
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> Unless the capital-recovery problem is addressed, investors cannot be expected to continue in the same terms as in the past. At best, investors will demand higher rates of return to compensate for the riskier environment. At worst, they will invest their capital elsewhere in the economy -- either the United States or abroad.

SPR, "The Depreciation Shortfall," attached to the Comments of the United States Telephone Association at 5.

meaningful recovery of the presently enormous depreciation shortfall.[112] As BellSouth shows in Attachment 2, its interstate depreciation imbalance is $579.4 million.[113] Until the Commission initiates such reform, however, LEC shareholders legally cannot be saddled with the legacy and bear the risk of under-recovery attributable to prior Commission decisions.

2. Recovery of Remaining Interstate-Allocated Embedded Costs (Paras. 256-259)

The Commission has invited comment on whether, as a matter of law or equity, incumbent LECs are entitled to, or should be permitted an opportunity to, recover the difference between interstate-allocated embedded costs and forward-looking economic costs that might be created by the Commission's proposed market-based or prescriptive access reform proposals.[114] The answer is yes. LECs are plainly entitled to an opportunity to recover all of their actual, prudently incurred costs of operations assigned to the interstate jurisdiction under Part 36 of the Commission's rules.

While the LEC entitlement to an opportunity for total cost-recovery is clear, the primary difference between a market-based and a prescriptive approach is the degree of flexibility granted to individual carriers to recover costs without having those methods prescribed by the regulator. For example, if the Commission were to institute a market-based approach initialized at existing

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[112] USTA estimates that the unseparated reserve deficiency is $17.9 billion for the price cap LECs.

[113] The depreciation parameters and data used in the calculation of the reserve deficiency are the same types of information that BellSouth has provided to the Commission for all asset accounts as a part of their regular depreciation filing requirements. The last study submitted to the Commission was in April 1995. BellSouth's view of the appropriate depreciation parameters has not changed significantly since that study was submitted.

[114] *See* NPRM at ¶ 256.

access prices, and as a consequence were to accord LECs the flexibility to establish their own depreciation rates, BellSouth believes that much of the existing reserve deficiency could be recovered without implementing any extraordinary measures.[115] Under a prescriptive approach, by contrast, there would be far less flexibility for LECs to recover embedded costs through existing rates. Thus, under a prescriptive approach, the FCC would likely be forced to adopt an explicit recovery mechanism that would be treated as an exogenous adjustment to existing LEC price caps. Under either regime, however, the critical legal test is whether the LEC has been afforded a reasonable opportunity to recover its costs.[116]

NARUC's suggestion that new sources of revenue from incumbent LEC in-region interLATA market entry might constitute a mitigating factor in evaluating the differential between embedded and forward-looking costs is without merit. In the first place, BOCs like BellSouth are precluded from entering the in-region interLATA market for three years after their separate affiliate begins operations under Section 272(f),[117] making NARUC's suggestion at best premature. More fundamentally, however, it would simply be illogical and entirely inappropriate to consider revenues earned by a separate Section 272 affiliate in order to recover BOC interstate-allocated embedded costs. To the extent a BOC receives additional jurisdictional revenues for

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115 BellSouth has suggested this approach in both the price cap and depreciation simplification proceedings, and indeed, currently has pending a Petition for Reconsideration in the latter proceeding that the Commission could use as a procedural vehicle to permit LEC control over their depreciation rates without beginning a new rulemaking proceeding, if it chose to do so. BellSouth Telecommunications, Petition For Reconsideration, CC Docket 92-296, December 6, 1993.

116 *See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920) (the Constitution forbids a firm from being forced to sell at prices that do not recover all of its true costs).

117 *See* 47 U.S.C. § 272(f).

network access from its Section 272 affiliate, those revenues will be counted towards interstate cost recovery under the existing Part 32 rules. Any other revenues received by the Section 272 affiliate, however, bear absolutely no relationship to recovering the costs of prudent investment in the LEC network and are irrelevant to the inquiry.

AT&T and MCI have suggested that LEC recovery should be limited to "those remaining embedded costs arising from certain sources, such as under-depreciation; the rest of LEC embedded investment would be dismissed and left unrecovered as costs resulting from "over-investment and other inefficiencies."[118] It is unclear precisely what AT&T and MCI mean in using these terms because they have never been specific. It appears, however, that AT&T and MCI are merely characterizing LEC actual costs as "over-investment" or "inefficient" relative to the output of their Hatfield model. And if that is so, then the positions of these parties should be rejected by the Commission.

The Commission legally cannot evaluate LEC investment decisions with the benefit of 20/20 hindsight; instead, the applicable legal standard examines whether LEC investments were prudent when made, and whether the resulting plant is "used and useful."[119] The fact that the resulting costs diverge from those estimated by a computer model that calculates LEC costs based upon a hypothetical, ideally efficient network utilizing the most advanced existing technology is and should be irrelevant to the Commission's inquiry.

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[118] *See* NPRM at ¶ 257, citing *AT&T November 22 Letter* at Appendix A.

[119] *See* 47 C.F.R. § 65.800; *See also Illinois Bell Telephone Co. v. FCC*, 911 F.2d 776 (D.C. Cir. 1990).

In responding to the Commission's query as to whether incumbent LECs should bear the burden of proof in demonstrating specific costs they seek to recover and satisfy a burden or standard to recover some or all of such costs,[120] BellSouth would make two points.

First, the Commission should not adopt such an approach unless it is given more evidence that there are in fact costs that have been inappropriately incurred by the LECs. In this regard, once again, there is no reason to suspect that the Commission's price cap regime has been ineffective in encouraging LECs to be efficient and cost-effective, and LEC investments under rate of regulation were periodically subject to state and federal review. In fact, as USTA has observed, crediting the MCI and AT&T claims, without a careful and full hearing, would be a fundamental violation of due process.[121] Unless AT&T or MCI can provide specific evidence to the contrary, previously promulgated LECs rates are entitled to a presumption of regularity,[122] and the Commission cannot and should not take action that disrupts the settled expectation that LECs and their shareholders will recover all of their costs.[123]

Second, and in any event, the Commission should consider the administrative burden that it would assume in adopting such an approach. If the Commission seriously intends to make a prudence inquiry regarding every investment decision of every incumbent LEC that culminated in the existing interstate rate base, it will truly be embarking on the "Mother of All Rate Cases." The Commission has never undertaken such an inquiry, even in the days when an AT&T interstate

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120 NPRM at ¶257.

121 USTA Reply Comments, CC Docket No. 96-98, at 25.

122 *See New England Grain & Feed v. USICC*, 598 F2.d 281, 285 (D.C. Cir. 1979) (absent evidence of unreasonableness, "previously promulgated rates bear a presumption of regularity.")

123 *Landgraf v. USI Film Prods.*, 114 S.Ct. 1483, 1497 (1994). (legal protections of settled expectations are grounded upon "sound considerations of general policy and practice.")

rate case would last for years,[124] and with respect to the substance of that inquiry, BellSouth wholeheartedly agrees with Sprint that it would be "impossible, as a practical matter, for this Commission or the states to attempt to determine, after the fact, how much of an ILEC's costs have been prudently incurred."[125] Once again, unless there is good reason to do so, the Commission should not initiate what will assuredly be a regulatory and administrative nightmare.[126]

In the final analysis, and contrary to the assertions of AT&T and MCI, the Commission has given LECs unambiguous incentives to reduce their costs, which have in turn been reinforced by the implementation of price regulation at the state level. There is no basis for the Commission to assume that the LECs have significant opportunities to reduce their costs that have not been voluntarily and diligently undertaken.

3. Recovery Mechanisms (Paras. 260-270)

In the event that the Commission decides (as it should) to establish a special opportunity for incumbent LECs to recover their embedded costs, BellSouth strongly believes that the

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124 On this point, the Commission should consider its experience in Docket 18128 and Docket 19129, which involved enormous expenditure of administrative resources for an interstate rate case that, in retrospect, is much narrower in scope than the proceeding now suggested by the Commission in Paragraph 257 of the NPRM, *See In the Matter of American Telephone & Telegraph Co. Charges for Interstate Telephone Service*, 27 FCC 2d 149, 155-56 (1971).

125 *See* Sprint Comments, CC Docket No. 96-98, at 60.

126 The Commission's suggestion that it could punt this enormous administrative burden to the States, NPRM at ¶ 258, is sorely misplaced. The Joint Board provision of Section 410(a) of the Communications Act upon which the Commission relies does not "assign the responsibility of conducting such rate cases to state commissions," as the NPRM suggests, *id.*, and in fact, the Commission is authorized to avail itself of such state cooperation and services only as the states "may" decide, in their discretion, to afford. *See* 47 U.S.C. § 410(b). In BellSouth territory at least, there is no reason to expect that the states would wish to do so.

Commission should establish a distinct recovery mechanism for existing depreciation imbalance and should rely a market-based recovery mechanism in the future. Such an approach will allow LECs to recover costs in the manner most suited to their specific costs and business operations. Thus, at the same time the Commission creates a reserve deficiency recovery mechanism, BellSouth urges the Commission to eliminate unnecessary regulations, grant the LECs pricing flexibility, forbear from prescribing LEC depreciation rates, and in general, allow the market to function.

The Commission seeks comment on two proposals regarding the recovery embedded costs.[127] The first purpose involves a mechanism designed to recover a specific, fixed dollar amount of remaining embedded costs over a fixed period; *e.g.*, by permitting incumbent LECs to "amortize" their recovery of the difference between forward-looking and embedded costs over a certain number of years. The second would establish a "surcharge," either on all access customers or on all telecommunications service users, in order to recover some portion of LEC embedded costs.

BellSouth believes that either of these two approaches could work as an effective recovery mechanism, though the amortization proposal would be easier to administer, and has been used successfully in the past to reduce depreciation reserve deficiencies. In the event that the Commission establishes a surcharge mechanism, it will confront the much more complex task of administering another universal-service-like recovery fund, albeit on an interim basis.

With respect to the recovery of the difference between forward-looking and embedded costs attributable to under-depreciation, the Commission has appropriately requested comment on

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[127] NPRM at ¶ 262.

the right balance between customer and shareholder risk as telecommunications markets become more competitive.[128] As the Commission recognizes, the incumbent LEC's ability to recover its investment in a competitive market is dependent in part on depreciation practices that accurately reflect the decline in economic value of the LEC investment.[129] The question is one of transition, and specifically, whether incumbent LECs should be afforded relief with respect to their current booked investment during a time of regulatory change.

The answer to this question is yes, and such relief should be in the form a specific mechanism designed to recover the existing depreciation reserve imbalance. To assure that future imbalances are not created because of inadequate depreciation, LECs should be permitted to take control over their depreciation rates immediately. Permitting LECs the flexibility to set their own depreciation rates will eliminate the need for special action by the FCC in the future. Thus, from the point in time that LECs are permitted to establish their own depreciation rates, the LEC will be able to set its depreciation rates in accordance with the market.[130]

Moreover, as the NPRM recognizes, emerging competition and the reforms recently triggered by Congressional enactment of the 1996 Act make solving the depreciation problem especially important. As LEC markets become effectively competitive, LECs can recover (and earn a return on) only the economic value of their capital; they cannot recover capital that exceeds economic value, even if the capital is in the regulatory rate base.[131] And once this happens, it

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[128] NPRM at ¶ 266.

[129] *Id.*

[130] Seven of the nine states in BellSouth's region have implemented price regulation rules that permit BellSouth to set its own depreciation rates

[131] SPR, "The Depreciation Shortfall," at 4.